ASAP™ A Littler Mendelson **Time Sensitive** Newsletter

in this issue:

SEPTEMBER 2007

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California Edition

A Littler Mendelson California-specific Newsletter

Gentry v. Superior Court: California Supreme Court Sets a High Bar for Enforcing Class Arbitration Waiver Clauses

By Douglas A. Wickham and Ryan P. Eskin

By a closely-divided 4-3 vote and over a vigorous dissent, the California Supreme Court broke new ground regarding the validity of class action waiver clauses in employment arbitration agreements. While upholding the validity of such clauses, the court created a new standard that may create formidable obstacles to enforcement as applied to overtime class action claims. *See Gentry v. Superior Court*, S141502 (Aug. 30, 2007).

In *Gentry*, the Supreme Court considered whether a class arbitration waiver clause in a pre-dispute employment arbitration agreement was valid and enforceable to preclude an employee from pursuing in arbitration class action claims for unpaid overtime. Concluding that the "prohibition of classwide relief would undermine the vindication of the employees' unwaivable statutory rights and would pose a serious obstacle to the enforcement of the state's overtime laws," the *Gentry* court reversed the court of appeal's decision that upheld the class arbitration waiver clause. Instead, the Supreme Court established new law governing such waivers, and remanded the case to the trial court to determine the validity of the class action waiver clause in light of the new standards articulated by the court.

The *Gentry* Case Facts and Background

The facts of the case are relatively straightforward. The plaintiff filed a class action lawsuit in superior court against Circuit City Stores, Inc. (Circuit City), seeking unpaid wages and damages for alleged violations of the California Labor Code and California's Business and Professions Code, as well as for conversion. When Gentry was hired by Circuit City in 1995, he received a packet that included an "Associate Issue Resolution Package" and a copy of Circuit City's "Dispute Resolution Rules and Procedures," pursuant to which employees are afforded various options, including arbitration, for resolving employment-related disputes. The agreement to arbitrate also contained a class arbitration waiver clause, which provided: "The Arbitrator shall not consolidate claims of different Associates into one proceeding, nor shall the Arbitrator have the power to hear arbitration as a class action ... ." The arbitration agreement also contained limitations on damages, recovery of attorneys' fees, and the statute of limitations that were less favorable to employees than were provided by California law. The packet included a form that gave the employee 30 days to opt out of the arbitration agreement. However, Gentry did not exercise this option and he did not opt out of the arbitration agreement.

After Gentry filed a lawsuit in the state trial court asserting class action claims for unpaid overtime, Circuit City moved to compel arbitration. The trial court, acknowledging that the governing case law was "conflicting and in a state of flux," ordered the plaintiff to "arbitrate his claims on an individual basis and submit to the class action waiver."

The court of appeal twice denied Gentry challenges to the trial court's decision. The court of appeal reasoned that the arbitration agreement, with its class action waiver clause, was not unconscionable because Gentry had been given the opportunity to opt-out of that agreement. The court of appeal also found that the Circuit City class arbitration

waiver clause to be distinguishable from the one found to be substantively unconscionable in the lead California case on this subject, *Discover Bank v. Superior Court*, 36 Cal. 4th 148 (2005) ("Discover Bank"), because the present case did not involve "predictably ... small amounts of damages."

After the court of appeal upheld the trial court on the second appeal, the California Supreme Court granted review to "clarify" its holding in *Discover Bank* and then reversed.

Discover Bank

In *Discover Bank*, the plaintiff sought to prosecute a class action against a credit card company that had allegedly defrauded a large number of customers for small amounts of money, as low as $29 in the plaintiff's case. In turn, the credit card company sought to compel the plaintiff to arbitrate his individual claims against the company and it sought to prevent the plaintiff from pursuing class or collective action claims against the company in light of a class action waiver clause in the arbitration agreement.

Agreeing with an earlier trial court ruling, the California Supreme Court held that the existence of the class action waiver clause rendered the *Discover Bank* arbitration agreement unconscionable. However, the court's ultimate conclusion invalidated such waiver clauses only within a narrow set of circumstances that did not, on its face, apply in the employment context. The *Discover Bank* court held that:

> [W]hen the [class action] waiver is found in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amounts of damages, and when it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money, then, at least to the extent the obligation at issue is governed by California law, the waiver becomes in practice the exemption of the party 'from responsibility for [its] own fraud, or willful injury to the person or property of another.' (Cal. Civ. Code, § 1668.) Under these circumstances, such waivers are unconscionable under California law and should not be enforced.

Moreover, the *Discover Bank* court expressly stated that "[w]e do not hold that all class action waivers are necessarily unconscionable." In *Gentry*, the California Supreme Court granted review to "clarify" its decision in *Discover Bank*.

Shifting Directions and Making New Law, Gentry Establishes a High Bar for Enforcement of Class Action Waiver Clauses in Employment Arbitration Agreements

The California Supreme Court in *Gentry* began its analysis by reaffirming its prior decision in *Discover Bank* that "some class action waivers in consumer contracts" are unconscionable, and thus, unenforceable. However, the *Gentry* court quickly shifted gears and began examining whether class action waiver clauses in cases involving statutory overtime claims may be contrary to California public policy.

At the outset, the court analyzed Sections 510 and 1194 of the California Labor Code and the statutory requirements in those sections governing non-exempt employees' right to overtime pay in California. The court found that "Labor Code section 1194 confirms 'a clear public policy ... that is specifically directed at the enforcement of California's minimum wage and overtime laws for the benefit of workers.'" Although overtime and minimum wage laws may at times be enforced by the Department of Labor Standards Enforcement (DLSE), it is the clear intent of the Legislature in section 1194 that minimum wage and overtime laws should be enforced in part by private action brought by aggrieved employees. After reviewing the public interests and policies supporting California's overtime laws, the court concluded that "the statutory right to receive overtime pay embodied in section 1194 is unwaivable."

The court then pivoted and turned its focus to analyzing whether the enforcement of a class action waiver clause "would lead to a de facto waiver of statutory rights or whether the ability to maintain a class action or [class] arbitration is 'necessary to enable an employee to vindicate ... unwaivable rights in an arbitration forum.'" Ultimately answering that question in the affirmative, the court reasoned that class action waiver clauses could have an "exculpatory effect" that would "undermine the enforcement of the statutory right to overtime pay." In so finding, the court first observed that that "individual awards in wage and hour cases tend to be modest," citing a report in a law review article to the effect that the average recovery in a Labor Commissioner case was $6,038. The court found that such "modest" awards would not be sufficient incentive for individuals to pursue lawsuits for overtime pay.

Moreover, although the court acknowledged that a prevailing employee is entitled to recover attorneys' fees in overtime cases, the court noted that such fee awards are subject to a "reasonableness" standard, such that the employee's attorney may not be paid for all attorneys' fees incurred. The court therefore found that "there is still a risk that even a prevailing plaintiff/employee may be undercompensated for such expenses." As a result, the court then concluded that the class actions are a more effective/efficient means for enforcing the overtime laws: "Given these risks and economic realities, class actions play an important function in enforcing overtime laws by permitting employees who are subject to the same unlawful payment practices a relatively inexpensive way to resolve their disputes."

The next factor the court weighed when reaching its decision was whether "a current employee who individually sues his or her employer is at greater risk of retaliation." Concluding that current employees were at risk of retaliation for asserting overtime claims, the court pointed out that "federal courts have widely recognized that fear of retaliation for individual suits against an employer is a justification for class certification in the arena of employment litigation ... ."

The final factor the court considered was whether and to what extent "some individual employees may not sue [for overtime violations] because they are unaware that their legal rights have been violated." Quoting the New Jersey Supreme Court, the court noted that, in

the consumer context, "without the availability of a class-action mechanism, many consumer-fraud victims may never realize that they may have been wronged." The court extrapolated from this observation that the same may be true in the employment context in California: "Similarly, it may often be the case that the illegal employer conduct escapes the attention of employees. Some workers, particularly immigrants with limited English language skills, may be unfamiliar with the overtime laws."

Having concluded its review of these factors, the court announced a new test for determining whether a class action waiver clause should be enforced or not in pre-dispute employment arbitration agreements:

> when it is alleged that an employer has systematically denied proper overtime pay to a class of employees and a class action is requested notwithstanding an arbitration agreement that contains a class arbitration waiver, the trial court must consider the factors discussed above: the modest size of the potential individual recovery, the potential for retaliation against members of the class, the fact that absent members of the class may be ill informed about their rights, and other real world obstacles to the vindication of class members' right to overtime pay through individual arbitration.

After considering these factors, if the trial court concludes, based on these factors, "that a class arbitration is likely to be a significantly more effective practical means of vindicating the rights of the affected employees than individual litigation or arbitration, and finds that the disallowance of the class action will likely lead to a less comprehensive enforcement of overtime laws for the employees alleged to be affected by the employer's violations, [the trial court] must invalidate the class arbitration waiver to ensure that these employees can "vindicate [their] unwaivable rights in an arbitration forum."

Gentry thus set new standards governing enforcement of class action waiver clauses in pre-dispute employment arbitration agreements, at least with regard to overtime claims. When presented with such a situation, *Gentry* directs trial courts to consider the following factors:

1. the size of the potential individual recovery and whether it is "modest" or not;
2. the potential for retaliation against members of the class;
3. whether members of the class may not be informed of their rights; and
4. other "real world obstacles" to the vindication of the putative class members' right to overtime pay through individual, and not class, arbitration.

If, after considering these factors (which presumably must be supported by evidence), the trial court concludes "that a class arbitration is likely to be a significantly more effective practical means of vindicating the rights of the affected employees than individual litigation or arbitration, and finds that the disallowance of the class action will likely lead to a less comprehensive enforcement of overtime laws for the employees alleged to be affected by the employer's violations," *Gentry* directs the trial court to invalidate the class arbitration waiver clause. Conversely, however, if the trial court considers all of these factors and, based on the evidence presented, does *not* conclude that "class arbitration is likely to be a significantly more effective practical means of vindicating the rights of the affected employees than individual litigation or arbitration," and does *not* "find that the disallowance of the class action will likely lead to a less comprehensive enforcement of overtime laws for the employees alleged to be affected by the employer's violations," then the trial court should uphold the class action waiver clause.

In developing this new standard for enforcement of class action waiver clauses, the *Gentry* court did not "foreclose the possibility that there may be circumstances under which individual arbitrations may satisfactorily address the overtime claims of a class of similarly aggrieved employees, or that an employer may devise a system of individual arbitration that does not disadvantage employees in vindicating their rights under section 1194." However, the court made clear that "class arbitration waivers cannot, consistent with the strong public policy behind section 1194, be used to weaken or undermine the private enforcement of overtime pay legislation by placing formidable practical obstacles in the way of employees' prosecution of those claims." Although *Gentry* establishes a very high bar for enforcing class action waiver clauses in the face of overtime claims, the bar is not completely insurmountable and the court left the issue open for further development by employers and in the lower courts.

Lessons Learned from *Gentry* and Practical Advice for Employers

The good news for employers is that the California Supreme Court in *Gentry* did not invalidate all class action waiver clauses in employers' arbitration agreements. In fact, the court acknowledged that for various types of high potential value claims (i.e., discrimination claims), class action waiver clauses may survive scrutiny under the *Gentry* test. Yet at the same time, the court cast doubt as to whether class action waiver clauses would be enforced in the face of relatively low exposure overtime or minimum wage or other types of claims under the California Labor Code.

How trial and intermediate appellate courts will apply the *Gentry* test remains to be seen. Presumably, the burden should be with the party opposing enforcement of the employment arbitration agreement including the class action waiver clause. However, the *Gentry* decision does not speak to that issue. Nor does the court offer any guidance concerning the nature and quality of evidence that should be considered by the trial court when faced with a challenge to a class action waiver clause.

For example, the first factor under the court's test is whether the size of the potential individual recovery is "modest." In the written opinion, the court cited to various law review articles concerning the average recovery in Labor Commissioner cases (approximately $6,000) and suggested that such a claim was "modest." The court also distinguished age discrimination actions, where, according to the court, average individual recoveries is in excess of $250,000. Even if those two extremes were intended to represent benchmarks, there is a vast gulf between a $6000 claim and a $250,000 claim and the court offered no guidance as to which end of the spectrum favored enforcement of the class action waiver clause.

Likewise, with regard to the second and third factors – the potential for retaliation against members of the class and whether members of the class may not be informed of their rights – the court offered no guidance as to how those factors would be measured or how they would be proven. For example, if an employer had strong policies prohibiting retaliation and if the workforce was well informed as to their rights under the California Labor Code, would the employer satisfy those two factors in the *Gentry* test?

Finally, despite the specifically enumerated factors, the *Gentry* court seemingly invited trial courts to speculate as to whether "a class arbitration is likely to be a significantly more effective practical means of vindicating the rights of the affected employees than individual litigation or arbitration" and whether the "disallowance of the class action will likely lead to a less comprehensive enforcement of overtime laws" for the employees alleged to be affected by the employer's violations. Analytically, to frame the issue in that manner also appears to beg the question. As trial courts are supposed to be courts of law and equity, and the interpretation and enforcement of arbitration agreements are governed by the same principles of contract interpretation, one would expect that the trial court would resist the temptation to impose their will and instead would seek out concrete evidence to support or oppose such a conclusion. As a result, every hearing concerning the enforcement of class action waiver clauses may have the potential to devolve into evidentiary battles over the utility of the class action tool as the trial court attempts to divine whether a class action in the case before the court will most effectively achieve enforcement of overtime laws.

As for existing and future arbitration agreements and policies, Gentry does not reject the inclusion of class action waiver clauses in arbitration agreements and policies. At a very minimum, since such clauses may be upheld in cases not involving "modest" sums, employers can fend off harassing and burdensome class action claims in at least some circumstances through the use of such clauses.

Employers should also take measures, through revisions to written employment policies and enforcement of such policies, to prevent retaliation and to ensure that employees are well informed regarding their rights under the California Labor Code. This too may increase the chances that the employer can satisfy the second and third elements of the *Gentry* test.

Moreover, although the *Gentry* test is not based on the law of unconscionability, the court nevertheless evaluated whether and to what extent a so called "opt out" clause in an employment arbitration agreement would constitute a savings clause that could insulate an arbitration agreement from being invalidated. The court of appeal in *Gentry* credited the existence of an opt-out clause in Circuit City's arbitration agreement and found that that clause contributed to a finding of validity. The Supreme Court, however, rejected this analysis and found that the inclusion of the opt out clause in the arbitration agreement, by itself, would not salvage an otherwise infirm arbitration agreement where an employer does not provide a full and complete disclosure to employees regarding the pros and cons of arbitration versus litigation under the terms of that agreement. As it relates to class action waiver clauses, given the *Gentry* decision, such clauses in employment arbitration agreements will stand or fall under the court's new test regardless of whether they are accompanied by an "opt out" clause.

In the end, *Gentry* directs trial courts to evaluate the relative effectiveness of the class action device in the specific case when deciding whether to enforce the class action waiver clause. While lower courts have ample guidance as to whether and under what circumstances a class should be certified (*e.g.*, the case law developed under Federal Rule of Civil Procedure 23 and California Code of Civil Procedure 382), there presently are no cases or other precedent to guide the trial courts regarding the effective enforcement of overtime laws. Thus, the resolution of this issue will be left to trial courts and intermediate appellate courts for development in future cases.

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